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By John Mauldin

There are things in today’s markets that are simply astounding. They should not exist, yet they do. Why should US bills trade at negative interest? How can oil be trading at all-time highs in terms of spreads over the next year? Bank debt and bonds are trading at discounts not to be believed. Want some free money? I show you a trade that gives you (almost) just that. Fed funds at zero? Are we starting to push on a string? We’ll cover all this and more in this week’s letter.

But first a quick commercial. Not all money managers and funds have had losses this year, even though it may seem like it. My partners around the world can introduce you to some alternative funds, commodity funds, and managers which you might find of interest as you rebalance your portfolio at the end of this year. You owe it to yourself to check them out.

If you are an accredited investor (net worth over roughly $1.5 million), you should check out my partners in the US, Altegris Investments (based in La Jolla) and my London partners (covering Europe), Absolute Return Partners. If you are in South Africa my partner there is Plexus Asset Management. You can go to www.accreditedinvestor.ws and fill out the form, and someone from their firms will be in touch. All three shops specialize in alternative investments like hedge funds and commodity funds, on a very selective basis. We will soon be announcing new partners in other parts of the world. And if you are an advisor or broker, you should call them (or fill out the form) and find out how you can plug your clients into their network of managers.

If your net worth is less than $1.5 million, I work with Steve Blumenthal and his team at CMG. I suggest you go to his website, register, and then let them show you what the blend of active managers on his platform would have done over the past few months and years. These are primarily managers who will trade a managed account (using various proprietary styles) in your name, and are quite liquid. Again, if you are an advisor or broker and would like to see the managers on the CMG platform and how you can access them for your clients, sign up and let Steve and his team know you are in the business. The link is http://www.cmgfunds.net/public/mauldin_questionnaire.asp. And now back to the letter.

I’ll Pay You to Hold My Cash
In the last few weeks we have seen 30- and 90-day US Treasury bills trade every now and then at a rate of negative interest. That means someone is willing to pay for the privilege of having their cash in US Treasuries. This simply should not be. Why would anyone want to do this? Is this a sign the system is broken? Are we that scared?

Not really. There are some explanations for this seemingly bizarre behavior. First, banks are driving down the interest rates toward zero. Because their audits come at the end of the year, they want to be able to show a very liquid and pristine balance sheet. And what better way to do that than short-term US Treasuries? But that gets us near zero, not below. (And as noted below, the effective Fed funds rate is at zero, not the posted 1%.)

As David Kotok of Cumberland Advisors noted in a post: “We cannot find a single investor or institution or organization that would volitionally buy this T-bill at zero interest, let alone a negative yield. We have polled firms and agents and portfolio managers. We’ve asked people who range from sophisticated, high-net-worth individuals to multi-billion-dollar institutions. None would do it. We have asked professionals and skilled and trained consultants. All answer ‘not me.’ Foreign currency traders would not do this trade; they have other ways to hedge or structure without buying a negative yield. Another possibility is market manipulation or a pricing error. Not this time. All evidence points to the negative yield as seeming to be a market-driven price. This is a real puzzle on the surface.”

I have spent more than a little time over the years looking at alternative fund prospectuses and back-room operations, and have been involved in a consulting role for a few funds. Let me tell you how I think interest can get below zero in a perfectly rational market.

Let’s say you are trading futures or other leveraged products. You don’t need to put up all the money in order to buy a futures contract on oil or the S&P 500. You simply have to have a typically small amount of margin money at the clearing broker, depending on the nature of the contract. Many funds are required by their organizational documents to hold their cash in short-term Treasuries for liquidity purposes. They have no choice but to buy Treasuries. Some of these funds are quite large, and when they come to the market they come, as we say, “in size.”

If you are a trader on the other side of the trade and can make a little extra for scalping such a fund, then you do it. It doesn’t happen often, but it can and does happen when the demand for liquidity is as high as it is today.

I also called my long-time friend Art Bell, whose eponymous firm Arthur Bell and Associates audits a rather large number of commodity and hedge funds. He is one of the best in the business. He confirmed that he knew of at least one fund that had bought Treasuries at a negative interest rate, not because they were forced to but because they wanted instantaneous liquidity in case they got margin calls on some of their trades. They did not want to be forced to sell something at a larger loss than they would normally take,
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just because they did not have the cash. The very small negative interest was the price they willingly paid not to be put in the position of taking larger losses on a trade in a forced sale. Sounds like smart risk management to me.

I bet if we checked around we would find more than a few funds and managers who for one reason or another are willing (or forced to) buy Treasuries at negative interest rates. Such is the way in today’s surreal investment world. Art says that if this current environment persists, funds will find an alternative, such as third-party collateral deposits, rather than leaving deposits at a brokerage firm.

Pushing on a String

Speaking of zero interest rates, the posted Fed funds rate may be at 1%, but the actual market is trading at very close to zero. That means that banks can get money that is effectively free. The Fed meets next week in what was supposed to be a one-day meeting but which has now been scheduled for two. Guess they think there is a little more to talk about.

The Fed will cut rates next week. But with the effective real market rate now at zero, what difference does a cut make? I hope they do the right thing and go ahead and cut at least 75 basis points, if not more. That would stop the speculation and let them move on to quantitative easing and other allied policies, which we will explore in some future letter. Whether they should pursue some of the more radical policies is open for debate, but it is more important today for us to figure out what they are going to do and adjust our portfolios correctly than to debate policy.

As an aside, if it looks like Bernanke and Paulson are making all their policy moves “on the fly,” it is because that is exactly what they are doing. As would any person in their respective offices. There is no playbook with a set of standard policies and procedures that can be used in case of a credit crisis. They have to make up the plays as the game progresses, much as we did in pick-up football games as kids. “John, go long and make a left cut at the trashcan. And try not to drop it this time.”

There are very few real rules and laws, and Bernanke and Paulson have shown a willingness to ignore them if they seem to get in the way. This is a very pragmatic group that is trying to keep the economy from imploding. They only have a few theories and some loose analogies to what happened in Japan and maybe the US in the 1930s as guidelines. But those times had such major significant differences that it is hard to make a direct inference as to what did and did not work. As Yogi Berra is alleged to have said, “In theory, there is no difference between practice and theory. In practice, there is.” And when theories meet the rough hand of the market, they will be changed.

We are getting to ready to run a grand experiment on many theories in the world of economics. Will Ben and Hank (soon to be Tim) get it precisely right? And what is precisely right? Does the avoidance of a second Great Depression mean success? Will anyone be grateful? We all have seen pictures of Paulson looking so very tired and worn.
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I actually feel sorry for him. Who would want that job? I know this will not sit well with many readers, but I think he has done about as well as could be expected given the circumstances. Look at the previous Treasury secretaries under Bush. No disrespect to Mr. O’Neill or Mr. Snow, but would you really want someone with so little exposure to the capital markets in the current position? Compared to so many Treasury secretaries over the past 30 years, we are lucky to have Paulson at this time.

In any event, Paulson is pouring water on the fire as fast as he can. I doubt that Tim Geithner will do any different. If Geithner has a play book for avoiding deflation and depressions, he has not shared it with anyone. They will still be making the plays up as they go along next year. I just hope they call the right plays.

Free Money with that Credit Default Swap?

Today there are bonds you can buy and get the interest coupon, and then purchase a credit default swap (insurance) on the loan that is less than the interest you will get on the loan. Assuming you have a creditworthy seller of the credit default swap, it is risk-free money. You can make almost 1% on the spread! Lever that up a few times and it becomes interesting. (Except that you can no longer get money to really leverage it enough.) This should not be. Then why is it?

Because “… assets everywhere are being dumped in favor of cash, and corporate bonds are no exception. Second, corporate bonds are no longer that attractive as collateral for funding because counterparts are demanding more onerous terms in exchange for lending out cash in return.” (The Financial Times)

The corporate bond market is assuming an Armageddon Scenario. Barclays Capital writes that one would have to assume that US GDP will contract by 15% to make sense of the current bond spreads.

My friend and partner Nick Rees at Absolute Return Partners in London dropped me this note (emphasis mine):

“Leveraged loans had a particularly rough month with the average senior secured loan losing over 20 points in value and now trading in the mid 60s. The sell-off was largely driven by forced liquidations as hedge funds face substantial redemptions in the run-in to New Year. This is how crazy the loan market is: The worst ever default rate for senior secured loans is about 8%. If you assume a 35% annual default rate and a 50% recovery rate, your IRR to maturity is now in excess of 22%, using no leverage whatsoever. Either this is the investment opportunity of the century, or equity markets have seriously underestimated the economic downturn, and things are likely to get a whole lot worse for equity investors.”

Formerly stable credit funds that are mark-to-market are posting horrific numbers. Many of them have closed redemptions until the market comes back. Selling a fully secured loan at 60 cents on the dollar makes no sense; and many investors are happy the funds have closed, as forced selling by other investors would lock in their losses when the loans will surely recover much of the current mark downs over time. But forced selling by
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some funds mean that all funds have to mark down the loans to today’s value. Mark-to-market in this context is appropriate but it is still hard on your psychology while you wait, and especially as loans seem to keep dropping in value.

**Oil Does a Strange Contango Dance**

The oil market is said to be in contango. The definition of contango is: “A condition in which distant delivery prices for futures exceed spot prices, often due to the costs of storing and insuring the underlying commodity. It is the opposite of backwardation.”

This morning West Texas Intermediate January oil futures prices were (courtesy of Dennis Gartman) $45.80. This rises to $52.28 by just April. A few day’s ago, Dennis reports, the spread between the first and fifth futures months had risen to $8.06, the highest ever. When oil was at $147, the spread was an average of $3.25, or about 2.5%. You can buy January 09 crude futures at a stunning 34.5% lower than January 2010.

That means if you could find a place to store that oil, you could lock in a guaranteed 34% profit, less the cost of storage. Sounds like easy money. This is just something that shouldn’t be. But what this tells us is that storage for oil is very tight. Oil producers are leasing very large ships to store excess oil, as they cannot find places to store it on land. Storing oil on ships is expensive, so that cost of storage gets figured into the price of oil a year out.

The OPEC nations are not cutting back by any significant amount. Oil is backing up in the system. It is quite possible that oil could go a lot lower in the next few months as the world reels from a global recession, and that means the demand for energy will be down. Oil below $30? Without production cuts that is certainly in the realm of possibility.

As an example, let’s look at how shipping is holding up. The graphs below picture a rapidly deteriorating shipping business. Korean exports fell by 18% and Taiwan’s by 23% year-over-year ending in October. China’s shipping is rumored to be down by 3% on a valuation basis and by 7-8% on a volume basis. Prices in China are actually starting to fall, and Chinese authorities may soon have to deal with deflation.

China is in a situation eerily reminiscent of the US in the very early 1930s. A large trade surplus, far too much production capacity, and falling exports with a whiff of deflation. Hopefully they have studied what we did wrong and will not copy it. But we should pay attention.
This is not a world economic environment that is friendly to oil producers. Could oil fall below $30? It could if producing countries do not start to cut back on production. But many of the larger producers need as much money as they can to keep the lid on civil unrest.

Deutsche Bank and a private consulting firm called PFC, based in Washington, have determined that Venezuela needs the price of oil to average $97 a barrel to balance its accounts, while in 2000 that South American country only required the price to be $34. Look at this chart, courtesy of Dennis Gartman. It shows the price of oil that various countries need to balance their budgets.

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Russia will need $70 oil. These countries are going to need to produce and sell what they can, which is in conflict with the need to control production and move prices higher.

So far, the OPEC nations are not cutting back any significant amount of production compared with the destruction in demand. Oil is backing up in the system. Energy economist Philip Verleger suggests that OPEC should execute an “astounding 7.7 million barrels per day” just to restore market balance today. Global demand is down by
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over 5 million barrels a day to 81.6 million barrels a day. Non-OPEC countries produce almost 50 million barrels of oil. OPEC produces roughly 31 million, plus there are some other OPEC sources of about 5 million barrels equivalent in natural gas liquids. Thus, Verleger says OPEC oil production needs to drop by almost 25%, to somewhere under 24 million barrels a day. Think Iran or Venezuela will cut that much, given their need for cash to fund their regimes? Will Russia join OPEC and cut production? It will be interesting to watch Iran and Venezuela in the coming year scramble to maintain power.

It is quite possible that oil could go a lot lower in the next few months. Demand could fall further. If we are truly producing an extra 5 million barrels a day, the excess supply could be at all-time highs within a few months. Longer term, I still think oil is going higher; but it could be wild ride, and the longer term is now a lot further off. I would not want to be long oil for the next few quarters, until there is some serious growth in demand and some cuts in production.

The Tragedy of Bernie Madoff

And speaking of things that should not be, yesterday I was talking with a few fellow money mangers on a conference call when the news came that Bernie Madoff had been arrested and his fund was missing at least $17 billion, and maybe losses were as much as $50 billion. This is so very, very tragic, as it is not just large investors with well-diversified portfolios who lost here. Many smaller investors around the world had significant sums of money with Madoff. Far too many were not as diversified as they should have been. Some of the stories already surfacing are of horrific personal losses to investors and retirees who have no way to come back from such losses.

The fact that Madoff will spend the rest of his life in jail in no way compensates for the loss of so many people whose lives have been seriously impacted. It is just so terribly sad.

Madoff is a topic that comes up very often in alternative investment circles. I have been talking about his fund with friends at various conferences for almost a decade. “How does he do it?” we wondered. His fund posted steady 1-1.5% monthly returns since 1996, with only a few losing months in all that time. Supposedly he was doing something called split strike conversions. Some speculated that he was actually front-running trades in his market-making business. (Interestingly, regulators who looked at his market-making business never investigated the fund to see if he was doing just that, although I believe there were suggestions and other hints to them.) But arbitrage traders in the same arena could never figure out how he did it, and many were openly sceptical. Everyone, even the smartest trading shops, had losing months and quarters. But not Madoff. The fund was a complete black box and no one knew exactly what he did. Oddly, I have never met or known of anyone who has ever met a trader who came out of Madoff’s shop. I run into resumes of ex-traders at various other funds all the time. No one knew what he did, even employees in his (what seems to be legitimate) market-making business, which was walled off from his investment funds. This was a man who was once chairman of the Nasdaq Stock Market. He was trusted and looked up to.
There were signs if you looked for them. The lack of transparency, for starters. The fact that he did his own trades with his own firm and made commissions on them. There was no prime broker where the real assets could be seen. How do you run a $17 billion fund without a room full of traders? I have been on the trading floors of smaller funds, and there are scores of people. A fund that size should have a football field-sized trading floor. Even if it was computerized, there had to be programmers. And lots of them. And where were the geniuses who designed these programs? Jim Simons at Renaissance has hundreds of support staff for his operation. He is one of the best, and he has losing periods. The “auditors” of the Madoff fund was a firm that was located in one 13x18-foot room. For a $17 billion dollar fund? Really? Real audits take lots of manpower.

That being said, a lot of smart people invested in the fund. They trusted Bernie. And anyone who looked at those returns had to be a little tempted. After all, weren’t regulators looking at it? (The answer is no.)

Now we know how he made those returns. It was a Ponzi. Except this may have been larger than Enron and ultimately more damaging to more people than any scandal in the past. I remember writing a few years ago, in response to an article in Forbes about some minor hedge fund frauds, that all the losses of all the hedge fund frauds combined did not equal an Enron or WorldCom or just the plain old loss in a few larger companies in the Nasdaq in 2000-2002. I can’t say that now.

Note to my fellow alternative industry participants: There is going to be a rush by Congress to regulate hedge funds. The SEC tried to regulate hedge funds a few years ago but had to back away when the Supreme Court said they did not have the authority. When the stories come out over the next few weeks (and I have heard some that really cause me heartache), there will be hearings in Congress. Rules will be passed. Quickly. And they should be.

Instead of fighting regulation as many did last time, we should recognize that this is a war that cannot be won and bow to the inevitable and at least get a few benefits from regulation, like the ability to publicly post past performance (although given the carnage of late, that is not as attractive as when I suggested it a few years ago!). I am regulated by FINRA, the NFA, and the state of Texas. We have had an average of one audit a year by some regulator for the past five years. My firm is small and it does cost a lot, but it certainly does not keep us from operating and growing our business. And I must (grudgingly) admit it does keep us on our toes. So let’s sue for whatever terms we can in what should be recognized as a total surrender. And then move on.

When I was a young man I wanted to grow up to be a science fiction writer. The real world has turned out much stranger than I could dream at that time. There are just so many things which should not be.

Goodbye to the Ballpark
For most of the last 15 years, my office has been in right center field of the Ballpark in Arlington, home of the Texas Rangers, the local professional baseball team. The entire center field in the Ballpark was made into an office complex, which has worked out very well for all. I can walk out on my balcony and watch the games and have as many as 25 friends into my office to watch with me. It has been the ultimate little boy’s office, and I have enjoyed it. There have been many good times here.

But tonight we are packing up, and tomorrow we’ll move the office to Dallas, where I will work in my home along with my small staff. More and more of what we do is now done elsewhere, so we don’t need as much room. Not only do we save a very significant amount of money, Tiffani and I also save over an hour a day in commuting. As we began to think about it, that is about 225 hours a year, or almost five weeks of time. And the one thing we both need is more time. At the end of the day, it was the time savings. The office has been worth the money, I think. (I still have a few months on my lease and control the next five years, so if you are interested I would be glad to show it to you.)

There is a part of me that is a bit nostalgic, as I have spent so many Friday evenings here writing this letter to you, even when games were going on. I shall return, as I have friends in the office complex here. But that being said, I am really looking forward to the walk down the hall being my daily commute.

I am hitting the send button a little early, as they are literally going to take my computer in a few minutes. Monday I enjoy the new office for an hour before flying to Phoenix for a day, but back home Tuesday night. Then Friday I am off to New Orleans for a long working weekend with Tiffani, where we will do some real work on our next book, *Eavesdropping on Millionaires*. The deadline is rapidly approaching and we need to focus!

Have a great week! And remember to think about all the good times! And believe there will be lots more.

Your turning the page of life one more time analyst,

John Mauldin